Joint Committee on Taxation
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PREPARED STATEMENT OF
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HEARING ON PROPOSED TAX TREATY WITH BERMUDA
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS,
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Introduction

It is our pleasure to appear before you to provide staff assistance on the proposed treaty with Bermuda relating to the taxation of insurance enterprises and mutual assistance in tax matters, which your Committee is currently considering.

In preparing for this hearing, we analyzed the proposed treaty and consulted with outside experts who are familiar with the treaty, as well as with staff of the tax-writing committees. We also worked closely over the past week with staff of your Committee and with the Treasury Department.

In our testimony before the Committee in 1981, 1983, 1984, and 1985, in connection with proposed tax treaties and protocols then under consideration by the Committee, we discussed at length the purpose, function, and overall desirability of tax treaties. We will not repeat that testimony today. (Our 1981 testimony appears in Tax Treaties: Hearings Before the Senate Committee on Foreign Relations on Various Tax Treaties, 97th Cong., 1st Sess., 39-53 & 77-99 (1981)). In general, tax treaties have two main purposes. They are intended to prevent tax avoidance and evasion and to reduce international double taxation. The former purpose generally is achieved in U.S. tax treaties by means of a mutual agreement procedure and a provision for the exchange of information. Tax treaties also perform the important function of removing impediments to international investment and to the free flow of capital generally.

In the past, we have generally prepared pamphlets discussing proposed tax treaties under consideration by your Committee and made them available to you prior to your hearings on the treaties. The accelerated schedule for consideration of the Bermuda treaty, coupled with the final preparation of the conference report on the tax reform legislation (H.R. 3838), left us without sufficient time to prepare such a pamphlet on the proposed treaty. In addition, the Treasury Department's

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technical explanation of the proposed treaty was not made available to us until yesterday afternoon. We regret any inconvenience that our inability to provide a pamphlet may cause.

You have before you the Treasury Department's technical explanation of the proposed treaty, which describes the treaty's features in detail. We will not repeat such a description in this presentation. Instead, we would like to focus our discussion on the tax policy issues presented by the proposed treaty. We recognize that there are important non-tax factors as well that the Committee will consider in connection with the proposed treaty, including issues relating to national security and trade. Our exclusive focus on the tax issues raised by the treaty should not be construed as reflecting any judgment on our part about the relative weight that should be placed on tax and non-tax factors in reviewing the treaty.

The treaty does raise several significant tax policy issues which we analyze below in separate sections. The nature of these issues is such that, were the treaty to be considered from a pure tax policy standpoint, we would probably recommend that the Committee not recommend Senate approval. As indicated above, however, we recognize that there are unique non-tax factors that the Committee will take into account in deciding what action to recommend on the proposed treaty; how the tax and non-tax factors are to be weighed is obviously a question left to your judgment. If the Committee decides to recommend approval of the treaty, the Committee may wish to consider including in its report a statement that, due to the unique nature of the treaty, it is not intended to serve as a precedent for future tax treaty negotiations. As detailed below, the treaty departs in several respects from established principles of U.S. treaty policy. If it were considered to have a precedential value from a tax policy perspective, such a judgment would have major consequences for basic notions of what tax results tax treaties are intended to achieve.

Potential for double taxation

As we stated at the outset, one of the two main purposes of a tax treaty is to reduce international double taxation. International double taxation may occur when more than one country exercises taxing jurisdiction over the same income. For example, when a resident of one country receives income from a second country, both the country of the recipient's residence and the country from which the income was received (often referred to as the source country) may assert a claim to tax the income.

Bermuda has no taxes on income, profits, capital assets, or gains at the present time. It also does not impose any withholding taxes on payments to nonresidents. It appears then

that there is no potential under current law for double taxation--by the United States and Bermuda--of residents of either of the two countries. This makes the proposed treaty with Bermuda a highly unusual one from a tax policy perspective. To our knowledge, Bermuda does not have a double taxation agreement with any other country. Also, the Treasury Department has confirmed that the United States has not negotiated an income tax treaty with any other country without an income tax system. Entering into an income tax treaty with a country that has no income tax system represents a significant expansion of the tax treaty program.

Tax treaties typically reduce taxes on a reciprocal basis. That is, one treaty partner agrees to reduce its tax on the other treaty partner's residents on the condition that the other treaty partner in turn reduce its tax on the first treaty partner's residents. The proposed treaty is a departure from the reciprocity model. Since Bermuda has no income or similar taxes, the effect of the proposed treaty would be to reduce U.S. tax only. The treaty would provide no current Bermuda tax benefit to U.S. residents. On the other hand, it should be noted that, in general, the provisions of the proposed treaty are formally drafted in reciprocal terms. Thus, if Bermuda adopts any taxes in the future that are substantially similar to the U.S. taxes covered by the proposed treaty, those taxes will be reduced by the treaty on the same basis as similar U.S. taxes. Any such reciprocal benefit is probably more theoretical than real though, since the treaty covers only one industry, the insurance industry, staff is not aware of any U.S.-based insurers insuring Bermuda risks, and Bermuda has not indicated any immediate plans to introduce an income tax.

Treatment of income from insuring U.S. risks

Among the U.S. taxes covered by the treaty's article on taxation of insurance enterprises is the Federal excise tax imposed on insurance and reinsurance premiums paid to foreign insurers (hereinafter referred to as the insurance excise tax). This tax is covered to the extent that a foreign insurer or reinsurer does not reinsure the risks in question with a person not entitled to relief from the tax under the proposed treaty or another U.S. treaty. Covering the insurance excise tax means that any income of a Bermuda insurer from the insurance of U.S. risks would not be subject to the insurance excise tax, except in situations where the risk is reinsured with a company not entitled to the exemption, if that insurance income is not attributable to a U.S. permanent establishment maintained by the Bermuda insurer. This treatment is a departure from older U.S. tax treaties, although it appears in some more recent treaties such as the present treaties with France, Hungary, and Barbados.

Bermuda is a major center for the insurance and reinsurance of non-Bermuda risks, including U.S. risks. The waiver of the

insurance excise tax is the most significant tax benefit that the treaty provides to Bermuda. As explained in more detail below, the interaction of this treaty provision with existing features of U.S. and Bermuda tax law may allow some Bermuda insurers (and reinsurers) of U.S. risks to avoid tax in both jurisdictions. It may be argued, therefore, that the proposed treaty, rather than eliminating double taxation, eliminates all taxation in certain cases. If the conference agreement on the Internal Revenue Code of 1986 (H.R. 3838) is enacted, however, the scope of such tax-free treatment will be narrowed.

As already noted, Bermuda does not tax the income of its residents. A Bermuda resident insurer owned by, for example, Bermuda residents will frequently owe no U.S. tax, either, on income from the insurance of a U.S. risk under the treaty so long as the insurer does not (1) insure the risk through a U.S. permanent establishment or (2) reinsure the risk with an entity not entitled to an insurance excise tax waiver under the proposed treaty or another U.S. treaty. A Bermuda insurer with substantial foreign ownership (other than U.S. ownership) will not be eligible for the treaty waiver of the insurance excise tax under the treaty's anti-treaty shopping rules (discussed further below).

Many U.S.-owned insurers based in Bermuda may similarly pay tax to neither jurisdiction on income from insuring U.S. risks as a result of the interaction of the treaty and existing internal law. (It is the staff's understanding that most Bermuda insurers have substantial U.S. or other third country ownership.) Under subpart F of the Internal Revenue Code, 10-percent U.S. shareholders of a foreign corporation are taxed currently on the corporation's income from insuring U.S. risks if more than 50 percent (or, in some cases, 25 percent) of the voting power of the corporation is held by such shareholders. Many offshore insurers of U.S. risks avoid U.S. taxation under subpart F today because, for example, their U.S. ownership is relatively dispersed, that is, no more than 50 percent of their voting stock is held by 10-percent U.S. shareholders. No income tax is imposed on their income from insuring U.S. risks unless and until they pay dividends to their U.S. shareholders. The only U.S. tax that may be currently imposed is the insurance excise tax. As discussed in more detail below, the treaty's anti-treaty shopping rules do not disqualify Bermuda companies from treaty benefits on the basis of substantial U.S. ownership. (Such treatment of U.S. persons as qualified owners for purposes of the anti-treaty shopping rules raises the question (discussed further below) of whether it is proper U.S. tax treaty policy to provide an incentive to U.S. persons to locate their businesses outside the United States in order to gain U.S. treaty tax benefits.) Thus, Bermuda-based insurers with relatively dispersed U.S. ownership are eligible for the treaty waiver of the excise tax with respect to risks that they do not reinsure with persons ineligible for the waiver (or a similar treaty waiver).

Staff is informed that most U.S.-owned insurers of U.S. risks based in Bermuda are "captive" insurance companies. A captive insurance company may be defined as a company organized by one or more persons primarily to provide insurance protection to its owners or persons related to its owners or to reinsure risks previously insured by its owners or persons related to its owners. The conference agreement on the Internal Revenue Code of 1986 contains a provision that would subject to current U.S. tax the related person insurance income of offshore captive insurance companies that avoid such tax under present law because, for example, their U.S. ownership is relatively dispersed. Thus, if the tax reform legislation is enacted, the income of U.S.-owned captive insurers with respect to U.S. risks generally will bear current U.S. tax, notwithstanding the treaty waiver of the insurance excise tax. The tax reform legislation, if enacted, then, will prevent the no-tax result otherwise possible under the proposed treaty for a large category of insurers in Bermuda. It is possible, however, that U.S. risk insurers that have relatively dispersed U.S. ownership and are not captives (and would not, therefore, be affected by the legislation) might take advantage of the treaty in the future to operate free of current tax, by setting up operations in Bermuda. There may be non-tax obstacles to such arrangements though, staff is informed.

The U.S. income tax treaty with Barbados created a similar potential for tax-free operation offshore by certain Barbados-based insurers of U.S. risks. The reason is that Barbados does not tax insurance companies licensed under its 1983 Exempt Insurance Act and U.S. owners of a Barbados company do not disqualify the company from treaty benefits.

The Bermuda treaty, like the Barbados treaty, eliminates a U.S. source basis tax (the insurance excise tax) on amounts that will not be taxed by the residence country; moreover, in many cases, this relief inures to the benefit of U.S. persons, that is, the owners of the Bermuda- and Barbados-based insurers. The Treasury Department acknowledges that this result was unintended in the case of the Barbados treaty. The waiver of the excise tax is extended to Bermuda in the proposed treaty because of the Barbados provision, staff is informed. Because Barbados and Bermuda are competing centers for insuring nondomestic risks, fairness, it is argued, dictates that insurance-related treaty benefits granted to Barbados also be granted to Bermuda. Parity of treatment might also be achieved, of course, by reversing (by legislation or treaty renogotiation, for example) the Barbados treaty result that Treasury had not contemplated at the time that the Barbados treaty was concluded. In general, when the United States extends a tax benefit by treaty to one country either because of a special economic or political relationship between the United States and that country, through an oversight, or for some other reason specific to that country, other countries may request the same or a similar benefit in

subsequent treaty negotiations with the United States even though the particular reasons for granting the benefit in the earlier treaty may not apply with respect to the new prospective treaty partners. One possible policy problem in acceding to such requests is that the extension of the tax benefit may come to be viewed by prospective treaty partners as an automatic or unilateral concession by the United States for which little or nothing need be conceded in return.

In any event, the elimination of the U.S. insurance excise tax for U.S.-owned Bermuda insurers raises the issue of whether U.S. tax benefits should be provided, directly or indirectly, to U.S. persons in bilateral agreements, without specific legislative approval; as noted above, the waiver of the excise tax may ultimately inure to the benefit of the U.S. shareholders of a Bermuda insurer. This issue has been considered by this Committee in the past in connection with the question whether U.S. persons should be granted U.S. tax deductions or special tax credits by treaty. In September of 1981, the Chairman and ranking minority Member of the Ways and Means Committee and the Chairman of the Finance Committee submitted statements to this Committee, as part of the record of the hearings on the proposed Canadian and Israeli treaties, in which they expressed serious reservations with granting deductions by treaty. This Committee, in reporting favorably on the proposed treaty with Israel, indicated its concern with granting deductions to U.S. persons by treaty. The report stated that the Committee might recommend a reservation in the future. In 1984 and 1985, the Committee, in reporting favorably on the proposed Danish income tax treaty, indicated that it did not recommend a reservation on a provision that expanded U.S. deductibility of child support payments because the provision predated the Committee's 1981 expression of disapproval of special treaty deductions. The Committee also questioned the wisdom of the Danish treaty provision granting a special tax credit to U.S. persons for Danish oil and gas taxes; however, the Committee expressed sympathy for the argument that fairness required inclusion of the credit in the Danish treaty given the inclusion of similar credits in the U.S. treaties with the United Kingdom and Denmark. Objections to the special treaty credit have thus far prevented the treaty's ratification.

In considering the proposed treaty's extension of indirect U.S. tax benefits to U.S. persons, the Committee should be aware that the tax reform legislation, if enacted, will provide U.S.-owned captive insurers subject to its new captive insurance rules with an election that will have the effect of waiving the insurance excise tax. With respect to U.S. owners of captives making this election, then, the treaty will not provide an additional U.S. tax benefit. The election will, however, subject the related person insurance income of the electing captive to taxation as if such income were effectively connected with a U.S. business. Thus, the treaty and legislative waivers of the excise tax have different tax consequences.

Tax avoidance and evasion

As we noted earlier, one of the primary purposes of a tax treaty is to limit tax avoidance and evasion. A tax treaty generally serves this purpose by providing for the exchange of information and establishing a mutual agreement procedure. Exchanges of information are valuable to the tax authorities of treaty partners. Routine information, for example, can be useful to the IRS in determining whether U.S. persons receiving income from the treaty partner are reporting all of their income and properly computing their taxes.

The proposed treaty, as augmented by accompanying diplomatic notes, contains a comprehensive set of exchange of information rules. Information exchanged under the treaty may be of significant benefit to U.S. tax authorities in their efforts to enforce U.S. tax laws. In the past, Bermuda's bank secrecy laws, for example, have sometimes proved an obstacle to enforcement efforts in cases involving U.S. persons with business dealings in Bermuda.

Under the Caribbean Basin Economic Recovery Act, certain foreign countries entering into an exchange of information agreement with the United States that meets statutory requirements established by that Act will be eligible for special convention tax benefits (Internal Revenue Code sec. 274(h)(6)). A foreign corporation (excluding one organized in a U.S. possession) cannot qualify for Foreign Sales Corporation (FSC) benefits under the Tax Reform Act of 1984 unless the country in which it is organized either has entered into an exchange of information agreement that satisfies the statutory requirements just noted or has a income tax treaty with the United States with respect to which the Secretary of the Treasury certifies that the exchange of information program with respect to the country carries out the purposes of the exchange of information requirements of the FSC legislation.

The 1981 U.S. model income tax treaty, prepared by the Treasury Department, contains a detailed exchange of information article. While departures from the U.S. model provision are contemplated by the Treasury Department under certain circumstances, the model provision is nonetheless a standard against which to compare the proposed treaty's exchange of information rules. The Treasury Department has also published (in 1984) a discussion draft of an exchange of information agreement which the Department believes satisfies the statutory requirements of the Caribbean Basic Economic Recovery Act (the "CBI discussion draft"). The CBI discussion draft is derived from and expands upon the 1981 U.S. model treaty. The Treasury Department states in its technical explanation of the CBI discussion draft that a final agreement need not contain all of the provisions of the discussion draft to be acceptable to the

United States. The CBI discussion draft is, however, another standard against which to compare the proposed treaty's exchange of information provisions. The discussion draft, and the statutory requirements upon which it is based, are of particular relevance to the proposed treaty because, in its diplomatic note accompanying the treaty, the U.S. Government states that, upon entry into force of the treaty, the Treasury Department will be prepared to execute an executive agreement satisfying the statutory requirements in question which would provide special convention tax benefits to persons incurring expenses for attending business conventions in Bermuda. The Treasury Department's position is that such an executive agreement will satisfy those statutory requirements by incorporating the treaty's exchange of information rules.

In July, the Chairman of the Ways and Means Committee requested from the Secretary of the Treasury a detailed explanation of the elements of the exchange of information requirement contemplated under the proposed treaty and how it satisfies the standards legislated in the Caribbean Basin Initiative. We have been informed by the Treasury Department that its technical explanation of the proposed treaty provides the detailed explanation requested. The technical explanation was made available to us for the first time yesterday afternoon so we have not had ample opportunity to study it.

We understand the Committee's wish to act expeditiously with respect to the proposed treaty and have examined the treaty's exchange of information rules closely in the time available. We have not, however, had an ample opportunity to analyze the adequacy of the treaty's exchange of information rules. Nonetheless, we would like to make a few preliminary observations about those rules without stating any final conclusions about their adequacy. In connection with these observations, we would like to reemphasize the potential benefit to the United States of an exchange of information agreement with Bermuda. Even if that agreement proves narrower in scope than that contained in the U.S. model, recent U.S. agreements, or the CBI discussion draft, it may prove valuable in the IRS's enforcement efforts.

Our first observation is that the treaty's exchange of information provisions are substantially less detailed than those of the U.S. model, the CBI discussion draft, or the CBI exchange of information agreement with Barbados (the only CBI exchange of information agreement in force). With respect to the fiscal laws of the United States and Bermuda other than those relating to tax fraud and tax evasion, the treaty itself states only that the competent authorities of the two countries shall, through consultations, develop appropriate conditions, methods, and techniques for providing, and shall thereafter provide, assistance as appropriate in carrying out those laws. While the notes add a few specific requirements drawn from the U.S. model and CBI discussion draft, the references to

consultations and the development of appropriate methods contrast sharply with the detailed and, in many cases, self-executing information exchange requirements contained in the discussion draft and the CBI exchange of information agreement with Barbados.

Second, to qualify under the Caribbean Basin Economic Recovery Act, an exchange of information agreement must apply to information necessary and appropriate to carry out and enforce the signatories' tax laws with respect to all persons. It may not be limited to information concerning nationals or residents of the United States or the beneficiary country (see Internal Revenue Code sec. 274(h)(6)(C)(i)). The notes state that the United States and Bermuda agreed that, where the United States requests assistance with respect to a matter other than a criminal or tax fraud investigation which relates to a nonresident of Bermuda or the United States, a senior official designated by the Secretary of the Treasury shall certify such request as being relevant to and necessary for the determination of the tax liability of a U.S. taxpayer, or the criminal tax liability of a person under U.S. law. United States and Bermuda further agreed, according to the notes, that, in connection with any assistance relating to persons not resident in the United States or Bermuda, it must be established to the satisfaction of the competent authority of the requested jurisdiction that such assistance is necessary for the proper administration and enforcement of the fiscal laws of the requesting jurisdiction; where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of such assistance.

The notes can be read to limit the assistance that Bermuda will provide the United States under the exchange of information provision in connection with a civil tax matter (other than tax fraud) involving a U.S. citizen residing outside the United States or Bermuda. While the relevant statutory provisions of the Caribbean Basin Economic Recovery Act require the exchange only of such information as may be necessary or appropriate to enforce the signatories' tax laws, they do not place in the beneficiary country's sole discretion the determination of what information requested by the United States is necessary, as the notes apparently do with respect to noncriminal matters involving third country residents. In this regard, the notes also are inconsistent with the CBI discussion draft and the CBI exchange of information agreement with Barbados.

Third, the U.S. model exchange of information article and the CBI discussion draft, on their faces, apply to all taxable years not barred by the statute of limitations, whether such years begin before or after the treaty enters into force, or the requested information or documents are derived or created before or after the treaty enters into force. The Caribbean Basin Economic Recovery Act does not explicitly address this point; its exchange of information rules are not limited by their terms

to open taxable years beginning after an agreement enters into force or information derived after an agreement enters into force.

With respect to matters other than tax fraud and evasion, the proposed treaty's exchange of information rules are not effective for taxable years beginning before the treaty's entry into force if their application would result in the breach of an obligation to maintain confidentiality of information under the laws of the requested jurisdiction in effect on July 11, 1986 (the date of signature of the treaty). With respect to matters other than tax fraud or evasion, the exchange of information rules also are not effective under any circumstances for taxable years beginning before 1977. The notes elaborate on the foregoing limitations, as they relate to Bermuda's obligation to provide assistance. They make clear, for example, that "matters other than tax fraud and evasion" are civil tax matters other than civil fraud, and confidential information would only include information protected by Bermuda statutory and common law. The notes also provide generally that Bermuda would have no obligation to provide assistance even with respect to a taxable year beginning after the treaty's entry into force if Bermuda's provision of assistance would require it to cause any person to breach a legal obligation to maintain confidentiality of documents or information, properly asserted by such person under Bermuda law as in effect on July 11, 1986, where such documents or information were created or derived from periods prior to the date of the treaty's entry into force. This limitation on Bermuda's obligation to exchange information with respect to post-entry-into-force years will not apply to documents or information created in or derived from a date preceding the treaty's entry into force if it is relevant to a request relating to taxable years after such entry into force and is of a kind that has a continuing operational effect, the notes state.

The foregoing limitations on the application of the treaty's exchange of information rules are not contained in the U.S. model, the CBI discussion draft, or the CBI exchange of information agreement with Barbados. It might be argued that such limitations are appropriate because of taxpayer reliance on confidentiality laws in effect prior to a treaty's signature. On the other hand, these limitations do not apply under the proposed treaty to information relevant to tax fraud and evasion. It is not clear that exchange of information requirements should be relaxed because a tax matter is civil rather than criminal in nature; indeed, most IRS investigations are civil rather than criminal.

Fourth, the CBI discussion draft requires the enactment of such legislation as may be necessary to effectuate its provisions. Staff is informed by the Treasury Department that, late last month, Bermuda enacted legislation that is intended to allow it to satisfy its information exchange obligations under

the proposed treaty. We have not yet had a chance to review the new legislation and, thus, cannot comment on whether it allows Bermuda fully to discharge its obligations under the treaty's exchange of information rules.

Fifth, the U.S. model, the CBI discussion draft, and the CBI exchange of information agreement concluded with Barbados contain an article outlining a mutual agreement procedure. The proposed treaty does not, although a few of the provisions of such an article are found elsewhere in the proposed treaty.

If the Committee decides to recommend ratification of the proposed treaty at this time, it might indicate in its report accompanying the resolution approving ratification of the treaty that the United States will reexamine the treaty if its exchange of information provisions do not yield adequate disclosure of tax information, or cooperation, by Bermuda or if it should later be determined that its exchange of information rules do not comply with the requirements of the Caribbean Basin Economic Recovery Act.

Anti-treaty shopping provisions

To prevent international double taxation, income tax treaties reduce taxes in some cases. Tax reductions in a treaty between two countries sometimes attract third country investors. For example, an investor from Country A, which has no income tax treaty with the United States, may establish a corporation or other entity in Country B, which does have an income tax treaty with the United States, to make investments in the United States. This is called "treaty shopping." Under current law, treaty shopping is sometimes successful; that is, the United States sometimes collects less tax because the foreign investor has put a treaty country corporation between himself and his U.S. income.

The Treasury Department and the IRS have taken steps to reduce treaty shopping. Treasury has adopted a policy of denying treaty benefits to treaty shoppers in the new treaties it is negotiating. Congress has urged the Treasury to continue this policy, so as to limit treaty benefits to bona fide residents of the treaty country. (See House Comm. on Ways and Means, Supplemental Report on the Tax Reform Act of 1984, H. Rep. No. 432, part 2, 98th Cong., 2d Sess. 1343 (1984).) The IRS has issued rulings to limit some treaty benefits to real treaty country residents (Rev. Ruls. 84-152 and 84-153, 1984 C.B. 381). In addition, the Internal Revenue Code of 1986 (H.R. 3838) contains provisions that would prohibit treaty shopping in certain circumstances.

In 1981, this Committee recommended that the Senate return two income tax treaties to the President because of potential treaty shopping problems (Senate Comm. on Foreign Relations,

Report on Return of Two Tax Treaties, Exec. Rep. No. 43, 97th Cong., 1st Sess.) The Senate followed the Committee's recommendation (S. Exec. Res. 4, agreed to December 16, 1984). One of those treaties, that with Cyprus, was renegotiated by Treasury, reported upon favorably in its renegotiated form by this Committee (Senate Comm. on Foreign Relations, Report on Income Tax Convention with the Government of Cyprus, Exec. Rep. No. 8, 99th Cong., 1st Sess.), and ratified by the Senate. Similarly, ratification of the proposed income tax treaty with China was delayed several months because of problems with its limited anti-treaty shopping provision. It was ratified in July after amendment of the anti-treaty shopping provision by protocol.

The provisions of the proposed treaty with Bermuda that are intended to prevent treaty shopping differ from the provisions of the U.S. model treaty in some respects.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the 1981 U.S. model and some recent U.S. treaties. The U.S. model allows benefits to be denied unless more than 75 percent of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like some newer treaties) lowers the qualifying percentage to 50 percent, and broadens the class of qualifying shareholders to include residents of either treaty country and citizens of the United States. Thus, this safe harbor is considerably easier to enter, under the proposed treaty.

As discussed above, the inclusion of U.S. residents and citizens as qualifying shareholders will allow U.S. owners of some Bermuda-based insurers to operate such insurers free of the insurance excise tax. This could encourage additional movement of U.S. insurance activity offshore. On the other hand, a similar provision in the Barbados treaty, coupled with that treaty's exemption from tax for certain insurers, has already contributed to a favorable tax climate offshore for insuring U.S. risks. Also, the Internal Revenue Code of 1986, if enacted, will limit the ability of captive insurers to operate offshore free of U.S. tax. It should be noted, in addition, that, since the proposed treaty affects only the taxation of insurance enterprises, its potential for facilitating U.S. tax avoidance arrangements is less than that of more comprehensive treaties with similar anti-treaty shopping provisions.

In addition to the ownership requirement, the proposed treaty includes, as do the U.S. model and most recent treaties, a "base erosion" provision which denies benefits under the treaty if a substantial part of an entity's income is used to satisfy liabilities to persons who are neither residents of Bermuda, residents of the United States, nor U.S. citizens. Diplomatic notes to the proposed treaty state that the United States considers "substantial" for this purpose to be 50 percent

or, in other cases, a lesser amount. The reduced ownership threshold discussed above increases the pressure on the base erosion rule. Another concern that the staff has with the base erosion provision is its definition of liabilities for purposes of determining whether a substantial part of a company's income is used to meet liabilities to non-U.S. and non-Bermuda residents. The proposed treaty excludes from liabilities for this purpose interest or other expenses paid on insurance obligations. As part of an insurance obligation, a company will often obligate itself to pay interest on a policy. One problem that could arise, at least in theory, is that third country residents may attempt to use this provision to extract profits from a Bermuda company in which they have an interest by improperly characterizing payments to themselves or other third country residents as interest on insurance obligations.

Although drafted to limit abuse, the anti-treaty shopping provision of the proposed treaty may not, as indicated above, prevent all potential unintended uses of the treaty by third country investors. Since Bermuda has no income tax or withholding taxes, the proposed treaty presents considerable treaty shopping potential. An anti-treaty shopping provision that allows third country ownership of up to 49 percent of an enterprise organized in a country with no direct taxes, and up to 49 percent of such an enterprise's profits to be remitted tax-free, may encourage third country residents to use the treaty to the extent available. Experience has shown that if abuses develop after a treaty is ratified, it is very difficult to negotiate solutions. On the other hand, since the treaty reduces U.S. tax in limited respects only (for example, it differs from most recent treaties in not limiting U.S. withholding taxes on dividends, interest and royalties), any abuse potential may be limited. The Committee might consider recommending a delay of ratification pending negotiation of an anti-treaty shopping rule that more closely parallels that of the U.S. model treaty if it considers the abuse potential serious.

Relationship to tax reform

As the Committee is aware, the Congress is now considering tax reform legislation (H.R. 3838) that has as one of its goals the removal, where possible, of non-tax factors from the determination of whether particular tax benefits should be provided. The proposed treaty obviously represents a step away from that goal. As we said at the outset, however, we recognize the unique nature of the non-tax issues presented by the treaty and leave to the Committee the difficult task of determining whether the importance of those non-tax considerations is such that the treaty's tax benefits should be granted.

Another issue that may be of concern to the Committee is the uncertainty that now exists about how the treaty and the tax reform legislation, if enacted, will interact in the years to

come. The drafting of the conference report on the tax reform legislation was completed only last week. (See H. Rep. No. 841, 99th Cong., 2d Sess. (1986).) The treaty was also formally submitted to Congress only last week. While we have identified two obvious interactions between the treaty and the tax reform legislation, which we discuss immediately below, less obvious interactions--and possible inconsistencies--may not come to light for some time, until the Congress, in particular, the tax-writing committees, have had a chance to study the treaty and the reform legislation language side-by-side, in depth. At the same time, we fully appreciate the Committee's desire to act quickly on the proposed treaty.

One of the legislative provisions relating to the treaty that we have identified (adopted from the Senate tax reform bill) requires the Treasury Department to conduct a study to determine whether U.S. reinsurance corporations are placed at a significant competitive disadvantage vis-a-vis foreign reinsurance corporations by reason of existing U.S. treaty provisions waiving the insurance excise tax, specifically identifying those treaties that create a significant competitive disadvantage. A report on the study is due no later than January 1, 1988. The proposed treaty contains the excise tax waiver provision to which the study is addressed. As a practical matter, the inclusion of the waiver in the treaty with Bermuda has potentially greater impact than its inclusion in some other treaties because of Bermuda's relative importance as a center for the reinsurance of nondomestic risks. The Committee should be aware in considering whether to recommend ratification of the proposed treaty that its insurance excise tax waiver provision may prove inconsistent with future Congressional tax policy, should Congress, after consideration of the study, find a significant competitive disadvantage on the part of U.S. reinsurers as a result of such waivers. In its report on the tax reform legislation, the Senate Finance Committee expressed the belief that, if the study indicates that such a competitive disadvantage exists, the Secretary of the Treasury should renegotiate the relevant treaties to eliminate that disadvantage.

Second, the legislation confirms that U.S.-owned captive insurers of U.S. risks are free to operate offshore but says, in effect, that they will not receive more favorable U.S. tax treatment if they do so than such insurers operating in the United States. The proposed treaty seems to say the opposite in non-captive, non-closely held cases, since the insurance excise tax it waives is considered a substitute for the U.S. net tax applicable to U.S.-based insurers.

Limited scope of treaty

The proposed treaty with Bermuda would be the second tax treaty entered into by the United States covering only one

industry, in this case, the insurance industry. Along with the first such treaty, the U.S.-China agreement on shipping and aircraft income, the proposed treaty accordingly represents an expansion of the tax treaty process. It is not clear that a proliferation of limited treaties would be administrable, or would be the best way to use the resources devoted to the tax treaty program. The U.S.-China agreement on shipping and aircraft income was reported favorably upon by the Committee in 1983 and is currently in force. However, the Committee's report on that agreement included a statement questioning the desirability of concluding tax treaties limited to one or two industries. If the Committee decides to recommend approval of the proposed treaty, it may wish again to include such a statement in its report.

Treaties with tax haven countries

As indicated above, Bermuda has no direct income taxes. It also has no foreign exchange controls for certain exempted entities. By a variety of means, its government encourages foreign investment in Bermuda-based entities that conduct business outside Bermuda, particularly insurance companies. Bermuda has sought to promote itself as a center for financial activities for nonresidents and as a tax haven. The United States recently terminated a number of extensions of its treaties with the United Kingdom and Belgium to their former colonies and territories, some of which have tax haven characteristics. The issue is whether the benefits for the United States of an income tax treaty with Bermuda, such as trade and national security benefits, outweigh the possible disadvantage of appearing to legitimize Bermuda's tax haven function.

Renegotiation provision

According to the notes accompanying the proposed treaty, the representatives of Bermuda emphasized the necessity of including in the treaty additional provisions intended to prevent changes in U.S. income tax treaty policy from adversely affecting the economic position of Bermuda's insurance and tourism industries relative to those of U.S. treaty partners in similar circumstances under current U.S. tax treaty policy. The U.S. representatives were not able to accept such provisions. However, the U.S. Government recognizes, according to the notes, that insurance and tourism currently play a vital role in the Bermuda economy. The notes state that if, in the future, the income tax treaty policies of the United States change in a manner which would have a material, adverse effect on such Bermuda business activities, compared with existing circumstances, the U.S. Government would be prepared to reopen the discussions in order to take account of such change in policies.

The issue is whether a provision committing the United States to renegotiate a treaty if future changes in U.S. treaty policy adversely affect specified business activities in the treaty partner country represents sound tax policy. U.S. treaty partners are free to seek renegotiation of treaties as economic conditions and tax laws change, and often do. The United States has renegotiated and replaced a number of older tax treaties in recent years. The provision contained in the Bermuda treaty might appear to make such renegotiation mandatory, rather than voluntary, on the part of the United States, however. The provision confers a kind of "most favored nation" status on Bermuda. Because the proposed treaty relationship with Bermuda raises a number of serious tax policy issues, it can be argued that, even if such a provision might be appropriate in some circumstances, it is not appropriate here. On the other hand, the provision does not compel the United States to accept any particular adjustments in the treaty's terms in the event that discussions are reopened in the future. Also, somewhat similar provisions committing the United States to reopen treaty negotiations with a view to incorporating a treaty provision that will minimize interference with incentives offered by the treaty partner and will be consistent with U.S. tax policy vis a vis other countries have been included in some U.S. treaties with less developed countries.